Investors often toss around adages and simplified trading strategies based on historical statistics. *"Sell in May and go away"* is a popular recommendation to exit the market for the summer and return in the fall. That would have been good advice this year, as the S&P 500 index fell almost 9% through the summer months. *"As goes January, so goes the rest of the year"* implies that the equity market will end the year in the same direction it went in January – January 2011 was a positive month, but the jury is still out on 2011 as a whole. These adages work from time to time, but most are just backward looking averages with not much insight into the current market environment. There is one, however, which we believe is solid advice in most circumstances: *"The consensus is often wrong."* When the investment crowd piles into a particular idea and sentiment goes to extremes, it is usually a good time to look in the opposite direction. "Group think" tends to fall into two divergent camps: one is extrapolating current trends indefinitely, and the other is calling for a reversion to historical averages prematurely. In either case, investors following the consensus tend to miss inflection points in the market, which can prove costly. Sometimes consensus is right, but digging a little further below the surface is usually the more profitable strategy.

This month we discuss how the markets in 2011 chewed up and spit out many of the consensus predictions made by Wall Street strategists a year ago. We believe it is a good time to revisit this valuable lesson in light of the current Euro-centric, pessimistic expectations for the markets. As Baron Rothschild once advised, "Buy when there's blood in the streets, even if the blood is your own."

Treasury Yields: How Low Can They Go

One asset class which has become a habitual target of (incorrect) consensus opinion is fixed income. U.S. Treasury yields have trended downward since the Federal Reserve broke the back of inflation in the 1980s, and thus provided very healthy total returns for bond holders. Obviously yields have a floor of 0%, and so the further they fall, the more certain investors become that a turn-around is imminent.

It is true that yields have little room to *fall*, but they have stymied the consensus by largely remaining *flat*. During the last several years, the call for a reversal of bond yields has been rooted in arguments both bullish and bearish. Some investors have feared that ballooning government deficits will drive up the cost of borrowing, while others have attributed the inevitable rise in yields to a bullish outlook on the economy and equity markets.

> "Wall Street banks are cutting their holdings of Treasuries at the fastest pace since 2004 as the world's biggest bond firms bet that the economy will strengthen and demand for higher-yielding assets will increase."
>
> *"Wall Street Dumps Most Treasuries Since 2004 on Growth," Daniel Kruger, Bloomberg.com*
> *January 10, 2011*

Barron's surveyed 13 Wall Street economists and strategists last December, and the one-way results conveyed how broadly the belief in higher rates was held. Predictions for the 10-year Treasury bond yield on December 31, 2011 averaged 3.95%, with the range spanning from 2.50% to 4.75%. Just over a month from that date (November 28th), the 10-year is yielding 1.97%.

> "As noted in Barron's Current Yield column a few weeks ago, the consensus forecasts is for a rise in Treasury yields, especially by the second half of this year. Notwithstanding [Byron] Wien's potential surprise of sharply higher yields, the real surprise would be something else."
>
> *"Current Yield: Fed and Tax Deal Lift Forecasts," Randall W. Forsyth, www.online.barrons.com*
> *December 18, 2010*

While we concur that yields do not have much downside potential, we have maintained that the most pressing concern today for investors is safety. Despite the Fed pinning short-term rates to the ground, many investors have accepted low yields in return for a refuge from the volatility of risk-bearing asset classes. Ironically, fiscal problems around the world are helping to suppress yields in the U.S. as investors turn to Treasurys and the dollar as safe havens. With the massive consumer and government deleveraging cycle constraining growth, it is possible that yields may hover near current levels for some time to come – especially if the U.S. government can put its fiscal outlook on a sustainable path.

Municipal Bonds: Don't Let Me Be Misunderstood

Treasurys are not the only segment of the fixed market to be declared prematurely DOA; during the last several years, many in the financial community have predicted a meltdown in the municipal bond market. We addressed these concerns in detail nearly 18 months ago in our research piece, *"Fact Versus Fiction: The Truth About Muni Bonds"*. In June 2010, we argued that the incentive for cities and municipalities to maintain the ability to borrow in the open market is very high – unlike corporations, governments do not go out of business and have an indefinite need for financing.

Most municipalities are willing to drastically slash spending to avoid being shut out of credit markets, which is exactly what is happening across the country today. We also showed that investing in high quality, general obligation bonds[1] (GO's) has presented very limited risk of default historically. The table at right illustrates these negligible default rates for GO bonds.

10-Year Average Cumulative Default Rates, 1970-2009			
Rating	General Obligation Munis	Non General Obligation Munis	Corporates
Aaa	0.00%	0.00%	0.50%
Aa	0.02%	0.05%	0.54%
A	0.00%	0.07%	2.05%
Baa	0.00%	0.39%	4.85%
Ba	0.01%	5.10%	19.96%
B	0.00%	13.78%	44.38%
CaaC	0.00%	14.07%	71.38%
Investment Grade	0.01%	0.13%	2.50%
All Rated	0.01%	0.19%	11.06%

Moody's, U.S. Municipal Bond Defaults and Recoveries, 1970-2009

We published *"The Truth About Muni Bonds"* to address investors' growing concerns about the potential for a surge in defaults as budget woes in states like California dominated the headlines. The frenzy was heightened later in the year when prominent banking analyst Meredith Whitney predicted on "60 Minutes" that there would be 50 to 100 significant municipal-bond defaults in 2011 totaling "hundreds of billions" of dollars. She also called for an acceleration of outflows from the municipal bond market as state finances would deteriorate over the next several quarters (Q1 and Q2 2011).

The catastrophe predicted by Ms. Whitney not only failed to materialize, but default amounts have fallen in 2011. So far this year municipal defaults total only $2.8 billion, well below the $4.4 billion in 2010 and the $8.6 billion in 2009[2], and certainly nowhere near "hundreds of billions" of dollars. Though there have been two high-profile municipal bankruptcies[3] in 2011, both were due primarily to project mismanagement and not signs of broader problems. According to The National Association of State Budget Officers, *"The municipal markets are treating these public finance blunders as isolated incidences, signaling an understanding that these rare cases are not evidence of an underlying, systemic issue. For the most part, states and localities in spite of very difficult economic and fiscal situations have convinced investors that their bond principle and interest will be paid now and in the future."*[4]

California, the poster child for state budget woes, has shown remarkable resilience. Reduced issuance, as well as automatic spending cuts to be triggered by revenue shortfalls, has helped buoy California bonds. The state's debt has had the best performance in 2011 among the 26 states tracked by S&P's Municipal Bond indexes.[5]

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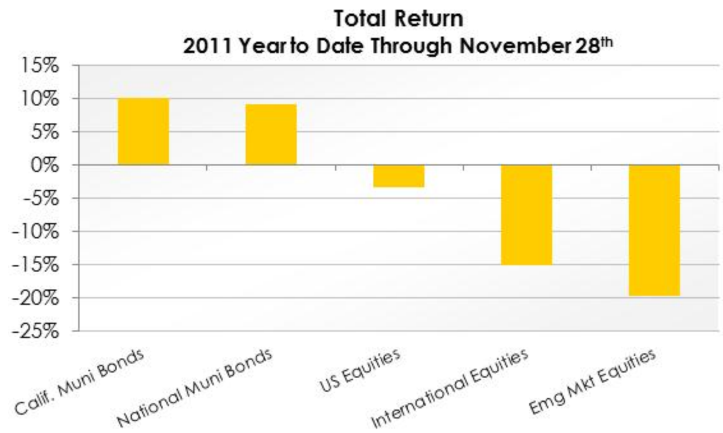
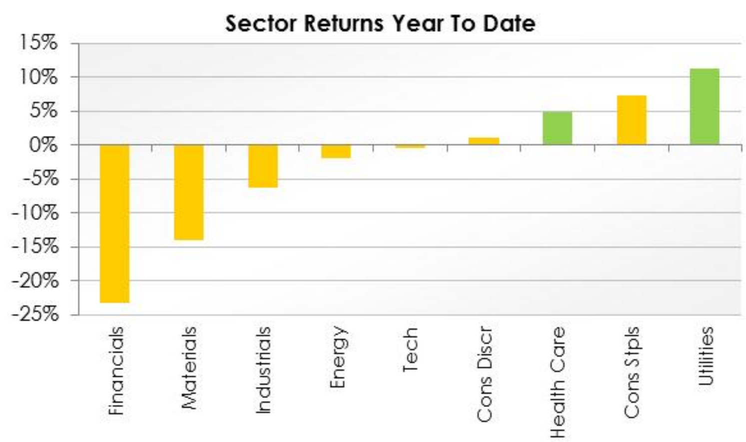
[1] General obligation bonds are backed by the credit and "taxing power" of the issuing jurisdiction..
[2] Bloomberg Brief: Municipal Market, November 21, 2011
[3] Bankruptcies were caused by mismanagement of the sewer system in Jefferson County, Alabama and the failure of an incinerator project in Harrisburg, Pennsylvania.
[4] Municipal Bonds In 2011: An Update On State And Local Borrowing, The National Association of State Budget Officers, November 23, 2011
[5] California Beating Bond Forecast Signals Falling Default Risk: Muni Credit, Michael B. Marois and Michelle Kaske, October 19, 2011, Bloomberg.com

In fact, municipal bonds returns in general have beaten many other asset classes handily year to date, particularly global equities markets. Digging below the surface to uncover the real versus perceived risk allowed us to recommend a laddered portfolio of short-to-medium term, high quality muni bonds for our clients, and this positioning has proven very beneficial to our clients in 2011.



Equities: Upside Down

Bonds have exceeded expectations so far this year, while equities largely have fallen short of consensus projections. Conducted in December 2010, Barron's annual survey of Wall Street strategists produced an average year-end forecast of 1373 for the S&P 500 index in 2011. On November 28th the index closed more than 15% below this mean forecast, and almost 5% below even the most pessimistic forecast in the survey. Although the year is not yet over, the S&P 500 would have to log its best month in more than twenty years to close near the mean forecast.



The Barron's respondents also came down on the wrong side of the sector call. The survey reported that in terms of sectors, *"The new pariahs are utilities and health care, which between them amassed 12 disses and just one nod."*[6] This implies that almost none of the strategists expected defensive, counter-cyclical sectors to lead the market this year. The chart at right shows that Utilities are the top performing sector year to date (Nov. 28th), with Health Care taking third place behind Consumer Staples. Sector leadership certainly can change during a period as long as a year, but at the time of the survey the equity market was just months away from a cyclical top in which defensive sectors took the reins.

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[6] Barron's Outlook 2011, December 20, 2010

Macro Themes: Not All Publicity Is Good Publicity

Mainstream financial publications have long been fantastic contrarian indicators. As Nobel Laureate economist Paul Krugman once quipped, "Whom the Gods would destroy, they first put on the cover of *Business Week*."[7] Last December, *U.S. News and World Report* published its "5 Investment Themes for 2011":

1. Deficits remain a concern
2. Trouble for Treasurys
3. U.S. stocks continue to sizzle
4. Emerging markets continue to lead
5. Gold loses its luster

While deficits have remained a major issue for the markets, both in the U.S. and abroad, the other four themes did not pan out. Treasurys have posted solid returns, U.S. equities are in the red, emerging markets have struggled to fight inflationary pressures causing their equity markets to stumble, and gold has continued its upward trajectory.

We admit it may be unfair to criticize with perfect hindsight – markets are dynamic animals and new information becomes available every day. However, there is a lesson to be learned. Markets have a way of hurting the most people possible, and so it is often useful to see where "most people" are headed, and evaluate if the opposite direction is more prudent. Despite consistently improving economic data in the U.S., investors have crowded the bearish camp as Europe's debt troubles intensified. We agree that structural debt problems weigh heavily on the developed economies, but cyclical trends still play out beneath the structural backdrop. The problems we face today have been present for the last several years, but during that time frame we experienced periods of both positive and negative equity markets based on cyclical forces. We believe that the current doom and gloom may provide an excellent entry point for investors wishing to move back to less-conservative allocations. Already we have shifted our Opportunistic holdings toward sectors positioned to benefit from better economic growth, and we anticipate increasing our allocation to risk-bearing assets in general very soon.

November 30, 2011

Katherine Krantz	Brock E. Moseley
Chief Economic Strategist	Chief Investment Officer

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[7] "The magazine cover effect," Paul Krugman, March 28, 2009

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